ALASKA'S FISCAL PROBLEM

The Past, Present and Future of Paying for Public Services

Fall 2001

THE NATURE OF THE PROBLEM

Alaskans have lived off the strong cash flow from North Slope oil fields beginning in the late 1970s and through the start of the 1990s. The annual tax and royalty revenues paid the bills for the public services that people had come to expect and enjoy.

Then, as oil production was in its downward slide by the early 1990s, Alaskans were able to enjoy the same services because we had the Budget Reserve Fund to pay the bills. Voters approved the reserve fund in 1990 as a savings account for future oil and gas tax and royalty settlements. The state had accumulated a hefty number of disputed tax and royalty cases, and the legislature asked voters to amend the constitution to set up the fund to hold the anticipated settlements. The fund was established to cover fluctuating oil revenues, allowing the state to maintain public services in years of low prices.

As expected, the reserve fund has received several large deposits of tax and royalty settlements. Since its start a decade ago, the account has received $5.5 billion, of which Alaska has spent $4 billion. The result is we continued to live off oil money in the 1990s — we just did it differently. Instead of paying our bills from the cash of current year's taxes and royalties, we spent our account receivables (our IOUs) as we collected them.

But all of the large tax and royalty cases have been settled, which means there are no more big deposits to replenish the reserve fund, which means we're running out of money and time, which means we have a problem.

The reserve fund started Fiscal Year 2002 (July 1, 2001) with about $3 billion. Based on current price and production assumptions, the Department of Revenue projects it will hit empty in the second half of calendar 2005. Our assumptions include a small increase in oil production over the next few years and a gradual return to historic average prices for Alaska North Slope crude. (The average daily production from the North Slope in Fiscal 2001 was 990,000 barrels, the lowest since the pipeline went into full production.)

No doubt Fiscal 2001 was a great year for oil prices, with North Slope crude averaging close to $28 a barrel — the highest in 17 years. But everyone knows the pains of price volatility. It was just two years ago, in Fiscal 1999, when oil averaged about $12 a barrel. That's why the reserve fund is so important to Alaska. We need it as a cushion, a shock absorber in years of low prices. If we drain it to cover our lack of a fiscal plan, it will not be around to cover its original purpose of holding steady our budget for public services.

The numbers tell the story of the state's reliance on oil revenues. In the 1980s, the state averaged about $3 billion a year in unrestricted revenue, of which $2.2 billion was from oil and gas. In the 1990s, the average revenues for a year dropped to $2.2 billion, of which $1.7 billion was oil and gas. In the first decade of the new century, we expect the average to fall even further, to $1.6 billion, with $1.2 billion of that from oil and gas. We just can't maintain public services for a growing population from a falling revenue source.

In addition to fluctuating oil prices and lower production, a third factor contributes to the revenue decline. The Economic Limit Factor (ELF) is a multiplier of the state's production tax rate designed to collect less tax on smaller, marginal fields, while maintaining a higher rate on larger fields. All of the new discoveries are being taxed at a lower rate than the declining fields at Prudhoe Bay and Kuparuk. Every barrel of "new" oil is taxed at a lower rate than the "old" oil it replaces in the pipeline. Even if total production holds steady, or increases a bit, production tax revenue to the state will continue to decline.

Production from the National Petroleum Reserve-Alaska could reverse the decline in state revenues, as could a natural gas project or production from the Arctic National Wildlife Refuge. But any revenues from those possibilities are at least several years away, and the Budget Reserve Fund probably will not last that long. Based on current projections, the Department of Revenue believes the state could face an unfunded budget gap of $1 billion by Fiscal 2006. Without the reserve fund to fill the gap, choices would include drastic cuts in public services, dramatic increases in existing taxes, cutting back on the Permanent Fund dividends and/or spending Permanent Fund earnings.

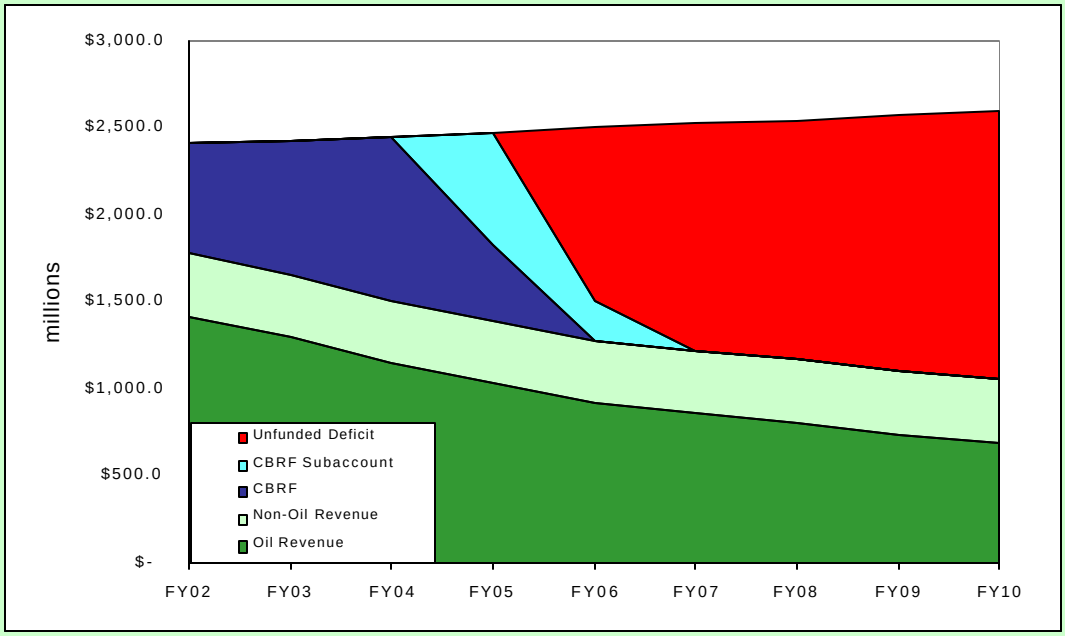
The Department of Revenue believes the state needs to maintain a reserve fund balance of about $1.5 billion to protect Alaskans from periods of low oil prices. The challenge before Alaskans is to put together a fiscal plan based on new revenues and wise spending before the budget reserve drops below a safe level.

Department of Revenue

Alaska's Fiscal Health

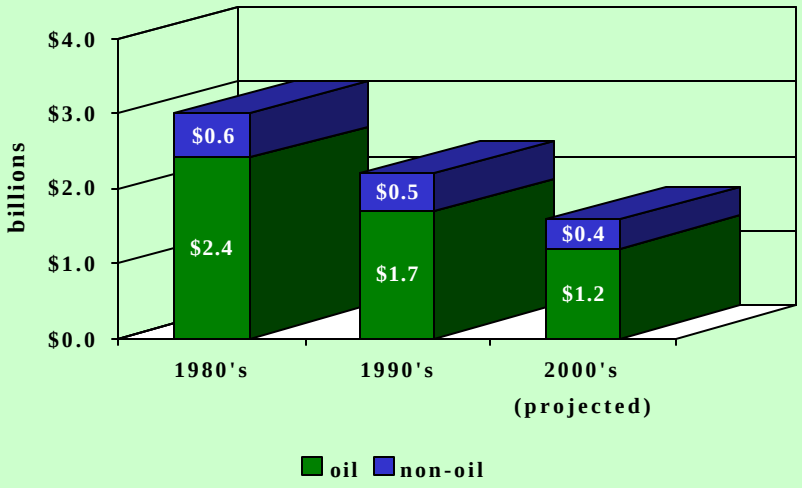
Fall 2001

State of Alaska Revenue Sources



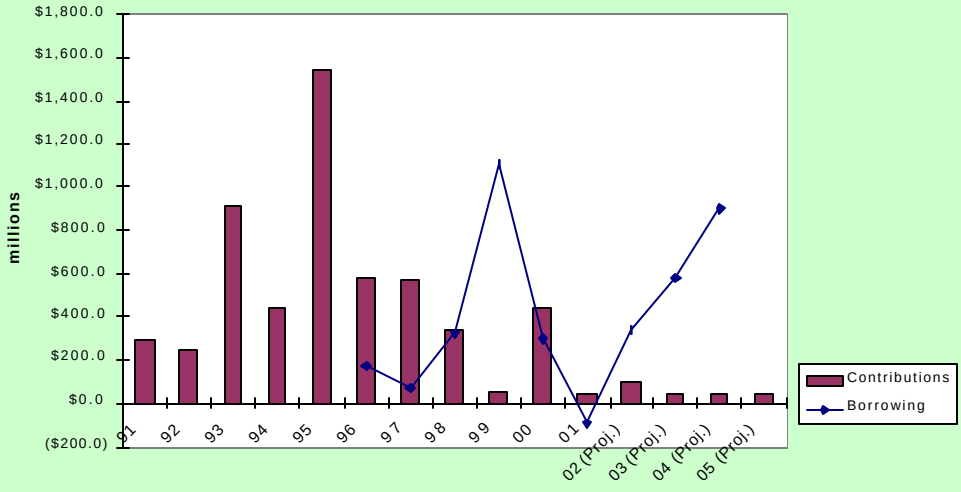
General Fund Unrestricted Revenue

Yearly Average For Each Decade

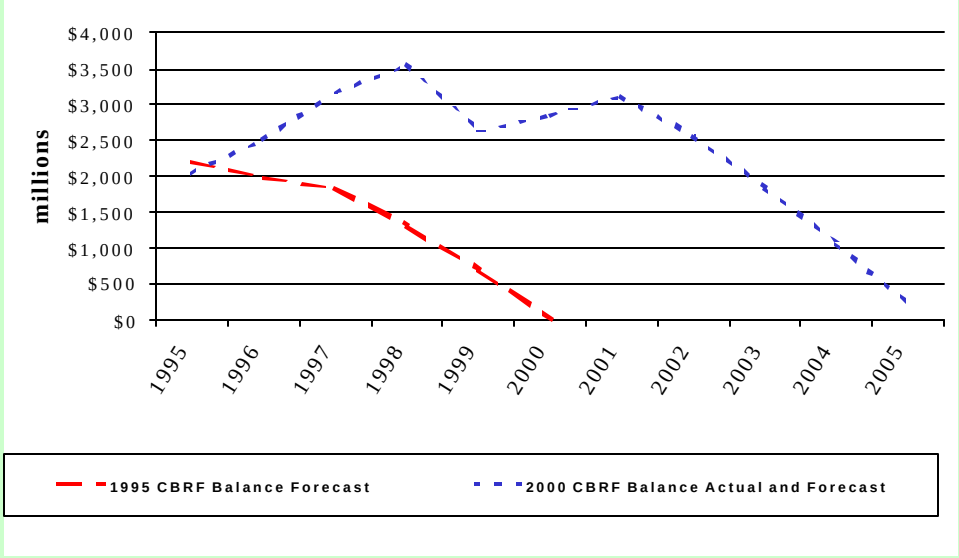


Constitutional Budget Reserve Fund

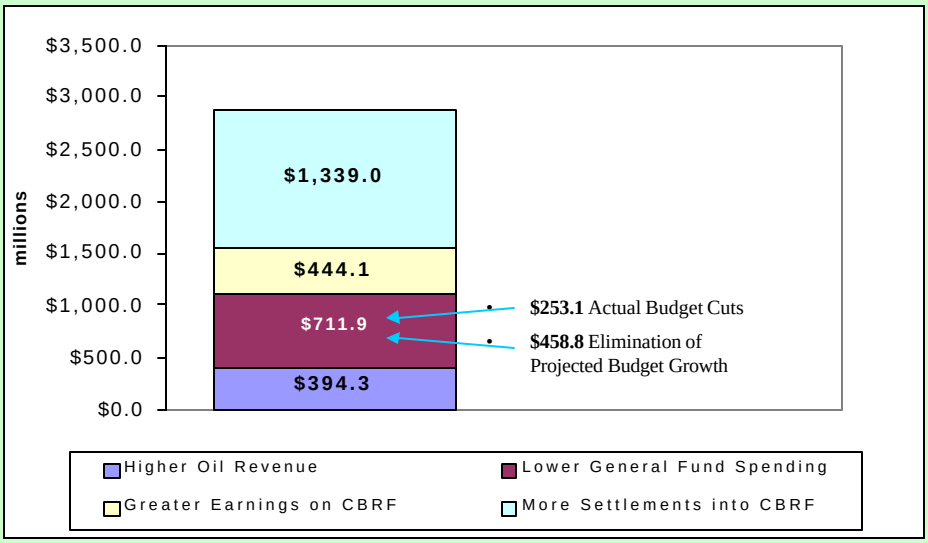
Settlement Contributions / CBRF Borrowing



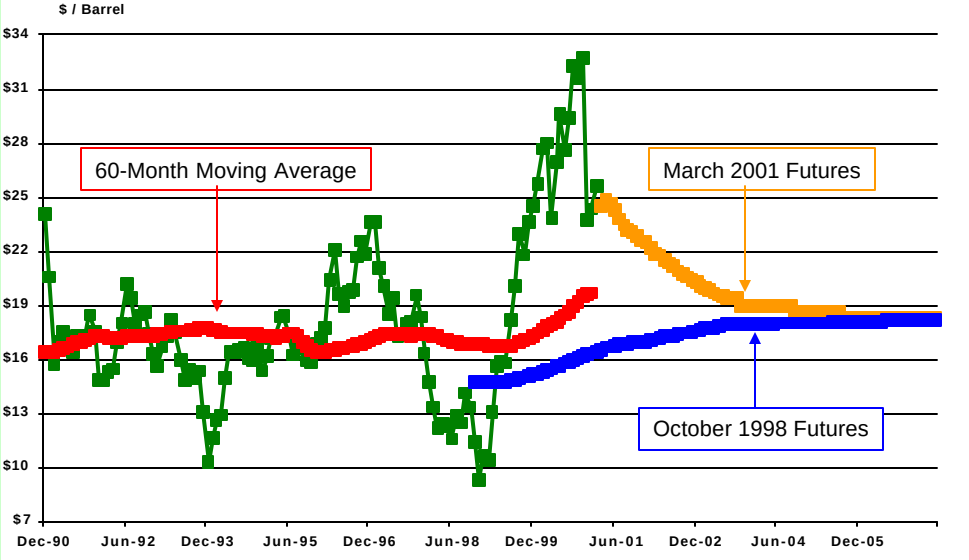
CBRF: The View from Here



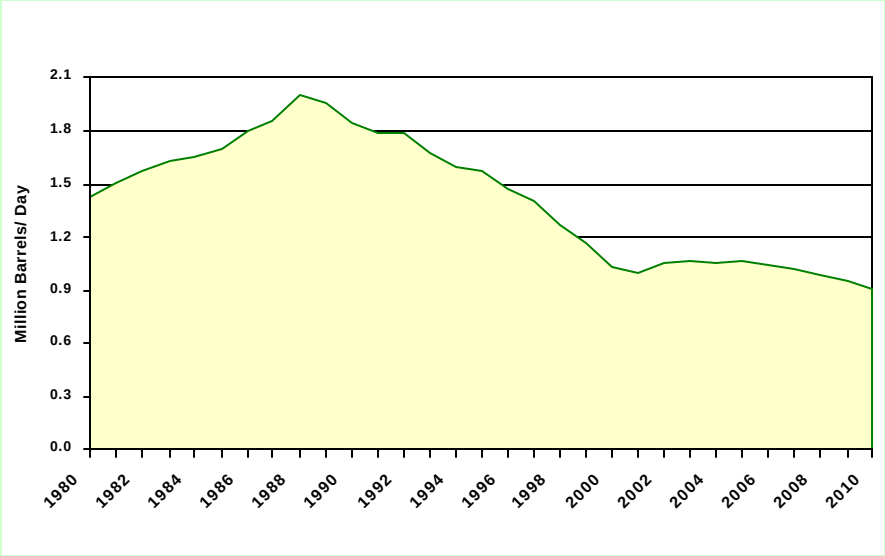
Why We Had More in the CBRF in FY 2000 than We Forecast in 1995



ANS West Coast and Futures Market Oil Prices

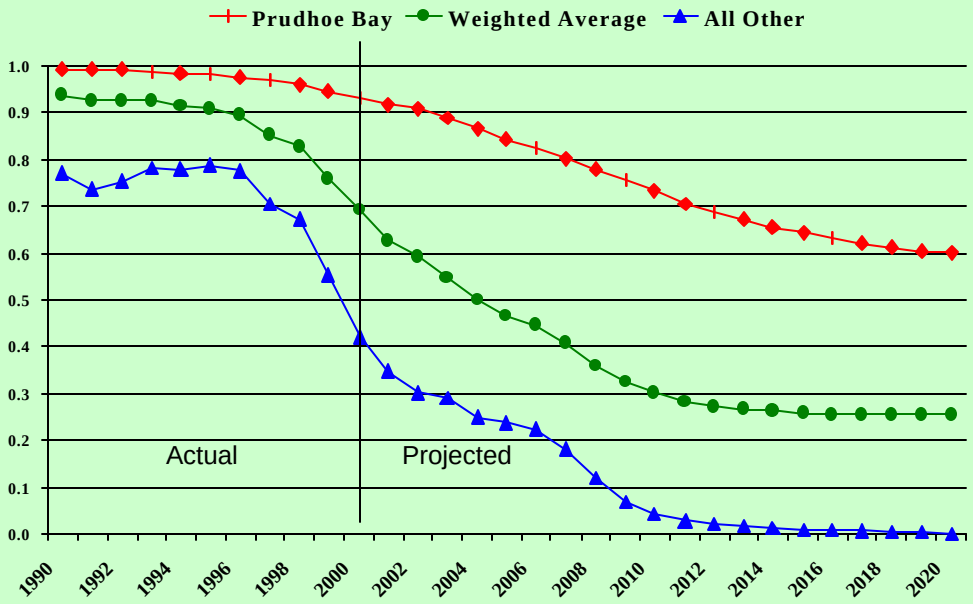


Total Alaska North Slope Oil Production

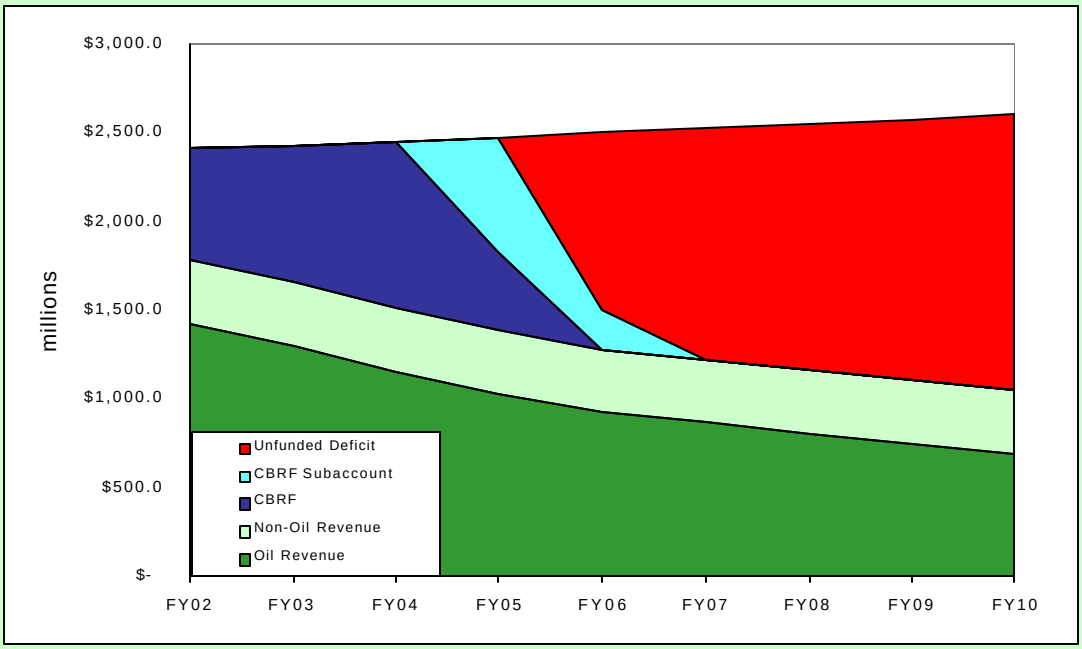


Economic Limit Factor

Tax-Rate Multiplier on Oil Production



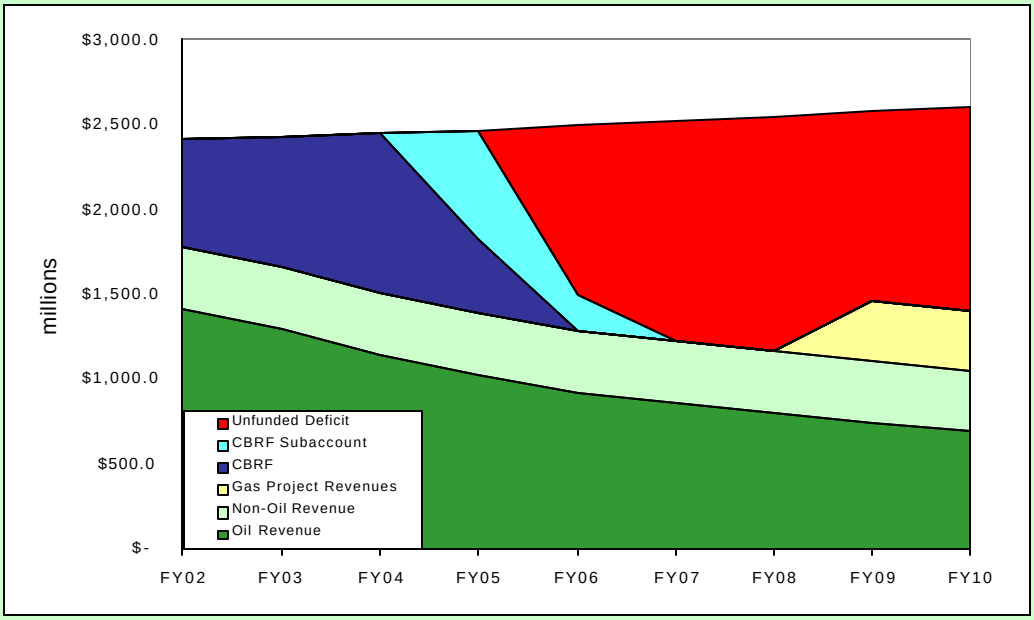
State of Alaska Revenue Sources



State of Alaska Revenue Sources

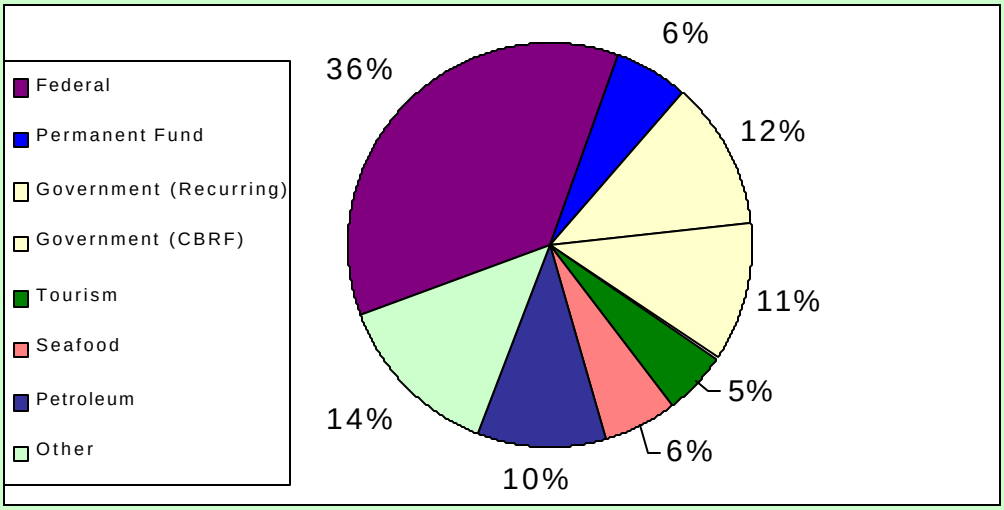
with

$350 Million Revenue from North Slope Natural Gas Project Starting in FY 2009



Replacing the CBRF with Money Already in the Economy Shrinks the Alaska Economy

Hypothetical FY 2006
Percentages of Personal Income



Is There Life After the CBRF Runs Out?

* Oil revenues will always be volatile.
* The CBRF has served as the state's cushion, or shock absorber, in years of low oil prices.
* A fiscal plan based on average oil prices would still leave the state at risk in years of low oil prices.
* If the CBRF is gone, how would we pay for public services when oil prices are below average?
* The Permanent Fund dividend and Permanent Fund earnings are options.
* Paying millions of dollars a year for oil futures to lock in prices also is an option. It's called hedging.
* The best plan is to keep $1.5 billion in the CBRF to balance the budget in years of low oil prices.

NOTES ON WHAT DRIVES STATE SPENDING

MAJOR ELEMENTS TO CONSIDER

- Changes in citizen needs and expectations – e.g. desire for better education or stronger law enforcement, increased business activity, more accessible state services
- Changes in federal and state requirements – higher standards, new laws
- Population – not just total number of residents, but the composition of the population.
- Inflation – not just overall rate, but inflation in specific service areas.

Overall Population Growth (charts 1 & 2)

History since statehood of volatile growth and contractions due to big projects in Alaska and economic conditions in Northwest feeder states.

A slowing US economy coupled with the prospect of a gasline and missile defense system increase the probability of another wave of migration just over the horizon.

Most migrants are young adults in their 20s and their children under age 5.

Rural Alaska has a younger population than the statewide average, a higher rate of natural increase, and residents are less likely to migrate out of state.

Private sector and state government are already experiencing severe recruitment/retention problems particularly in jobs such as information technology, engineers, health care workers, teachers and biologists.

Population by Age Group (charts 3-5)

Most expensive age groups in terms of state service costs – children, males 18 – 25, and seniors.

Peak of the echo of the baby boom is now 10-12 years old and in elementary school. The average cost per year of educating a K-12 student is $7,945.

Young men account for most of the criminal justice system costs: prosecution, courts, prison. Keeping an inmate in state prison costs $40,839 per year.

Public service costs associated with this bulge in the population will ripple through the criminal justice and higher education systems during the next 10 years.

Population of seniors is expected to mushroom during the next 25 years. The average state-federal cost for all Medicaid recipients is $516 per month, but seniors cost $1,209 per month (the disabled cost $1,624 per month). Pioneer Home costs average $5,973 per month (of which residents pay about 38%).

Inflation

Effects of inflation on public service costs can't be measured simply by the Anchorage CPI. Several specific rates of inflation apply to the range of state services. For instance:

- Inflation on medical services runs higher than the overall CPI. However, a small percentage increase has a significant effect on state spending, especially in Medicaid.
- Energy prices are a small component of the overall CPI rate, but higher fuel prices have big impacts on specific programs such as the ferry system, 24 hour facilities like Pioneer Homes, and Power Cost Equalization.
- Nationwide, the price of goods and services purchased by universities have risen much faster than overall inflation.

PER CAPITA SPENDING

In today's dollars, per capita state general fund spending for state services is $921 less than in FY79 when the oil era began. Combined operating and capital general fund spending is $1,186 less. (Chart 6)

But when Permanent Fund dividends are added to general fund spending, the total is $534 more per capita than FY 79. (Chart 7)

Why does the state spend more per capita in Alaska?

State by state comparisons often portray Alaska as spending more per person than other states. Obvious reasons: harsh climate, scattered communities, few economies of scale, high transportation costs and cost of living.

Other reasons may not be so obvious:

- Our state government provides services that are provided by counties or local governments in other states (police, prosecution, courts, jails, social services, etc.)
- Alaska pays a larger share of "local" costs such as education than do other states
- Vast resource management responsibilities – troopers enforcing fish and game laws cover 6 times as much area per officer as Wyoming; fewer oilfield safety inspectors than Indiana with 160 times the annual production
- Short time span since statehood for developing infrastructure including bringing rural villages up from third world to first world sanitation and health standards
- Alaska has programs that other states don't – Permanent Fund dividends, Longevity Bonus, Pioneer Homes, Power Cost Equalization, etc.

MAJOR CATEGORIES OF STATE SPENDING

Total Funds Budget (chart 8)

Much of the $7.2 billion total state budget has restrictions on how the money is spent.

Permanent Fund Earnings

About $1.8 billion of Permanent Fund earnings pay for dividends ($1.1 billion) and inflation proofing ($700 million). The PFD program is by far the largest single state expenditure and has been the fastest growing program for the past decade.

Federal Funds

About $2.1 billion is federal funding which has restrictions on how it may be spent and requires a $253 million state general fund match.

Other Funds

A little over $1 billion comes from sources such as university tuition receipts, AHFC dividend, endowment and trust receipts. Most of these funding sources have restrictions on how they may be spent, e.g., AHFC dividends are devoted to debt service payments on bonds and Public School Trust earnings are dedicated to school funding. This category includes self-supporting enterprises and activities like the international airports. Other funds do not figure into the fiscal gap.

Formula Programs

$1.6 billion goes for formula programs where the level of funding is determined by a formula set in statute – largest are K-12 education at $782 million and Medicaid at $577 million. Others include revenue sharing, longevity bonus, welfare, and foster care.

General Fund Budget (chart 9)

General funds are mostly oil revenues and the legislature has discretion over how they may be spent. The fiscal gap is measured as the difference between general fund revenues and general fund expenditures.

The large majority of expenditures in the general funds budget are committed to services that most people recognize as standard government functions.

> These include: K-12 education (29%), formula programs (14%), public safety (14%), university (8%), transportation (7%), health and social services (6%), natural resource management (4%) and debt service (4%).

The remaining 14% piece represents all other general government functions.

> These include: economic development, senior services, public health, motor vehicle services, revenue collection, finance, the legislature, the governor's office and many others.

Unmet Needs and Deferred Maintenance

In the past couple of years, resources for K-12 education, the university and child protection have been increased to partially meet the public demand for improved quality as well as to help offset the effects of prior years' inflation and population growth.

Recent investments in prevention of child abuse and neglect cost more in the short term but will pay off in reduced criminal justice system and other state costs in the future.

There has also been some progress in dealing with the enormous deferred maintenance backlog, particularly for K-12 schools and the university but also for harbors and public health facilities.

The deferred maintenance list for state facilities is nearly $200 million, not including schools or the university. Many state facilities built with large capital budgets in the early 80s are now reaching the point in their useful life when they need major repair, renovation or replacement.

State share of the remaining statewide school construction priority list is $387 million; rest of the current school major maintenance list is $72 million.

Growth in state spending to accommodate population and inflation is not a steady linear progression. For instance, we can add incrementally to the number of inmates or students for a while, but at some point we have to build a new prison or more schools.

Infrastructure built during the early 80s when the growth rate was very high and projected to continue has accommodated the lower growth rate of the 90s (e.g., Anchorage roads). However, prospective higher growth rates caused by big projects could quickly surpass these threshold levels requiring new infrastructure investments.

SUMMING UP AND LOOKING AHEAD

Projecting public service costs into the future is not just a simple mathematical calculation using a standard rate of growth for population and inflation – it's important to understand how the many factors within these overall rates will impact the budget.

Only a small portion of the overall budget is generally viewed as being completely discretionary. In many people's view, even the dividend payout, which is not a typical state function, has become a "staple" in Alaska's state budget.

Adequacy of services also feeds into determination of the appropriate budget level.

Flexibility for policymakers will be important as the state both responds to and helps shape Alaska's economic future, including how we address growth that comes with big drivers of state service needs such as the gasline and national missile defense projects.

Chart 1

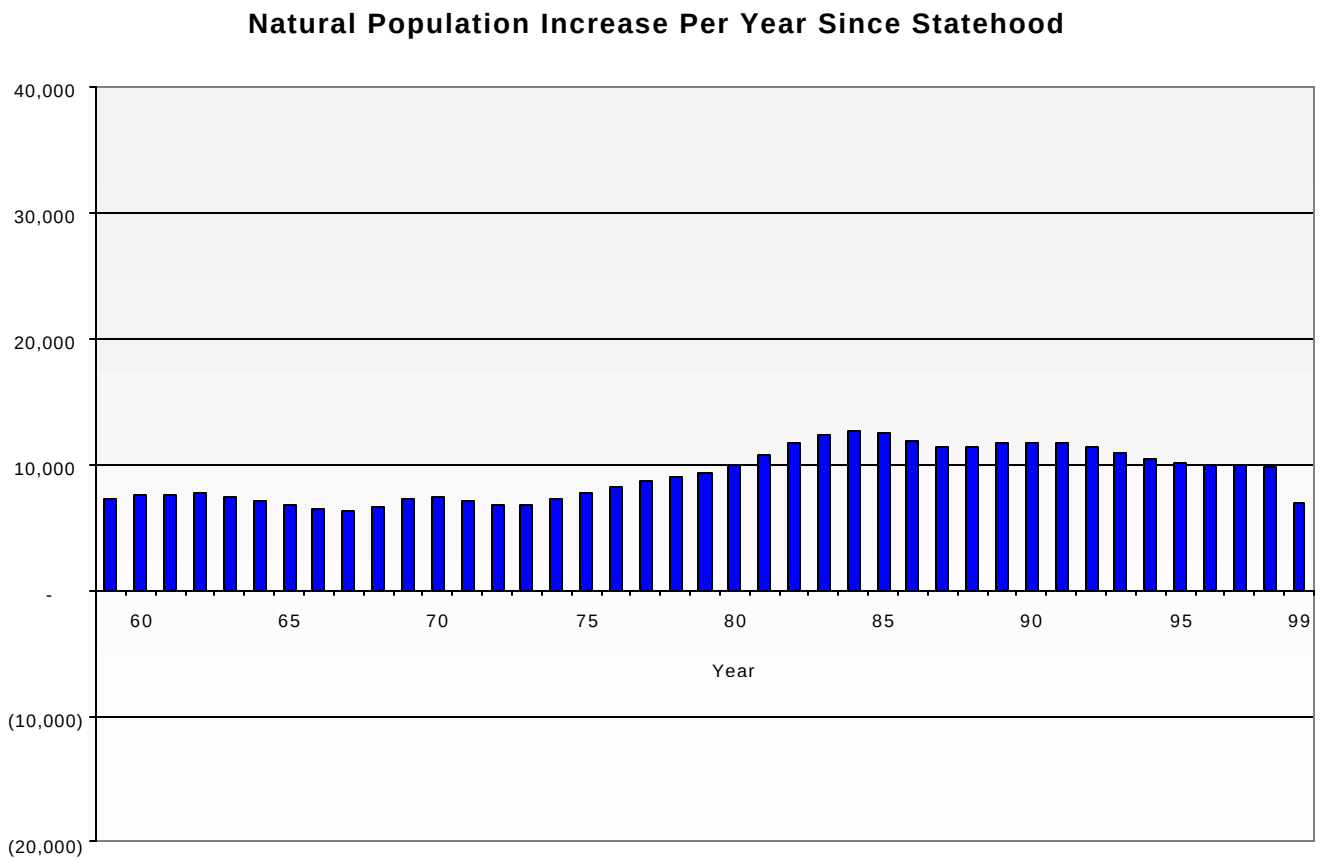
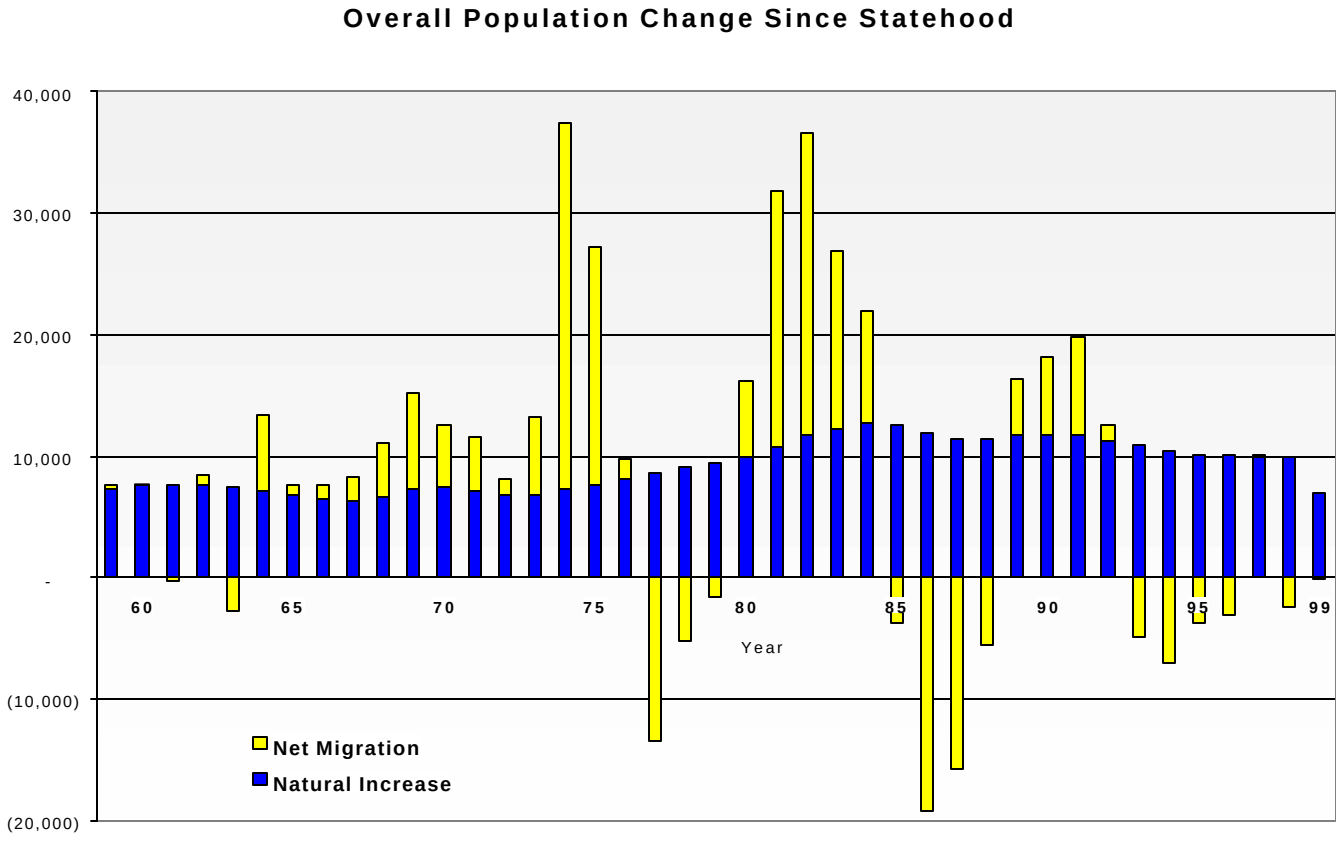


Chart 2



Office of Management and Budget, 07/01

Chart 3

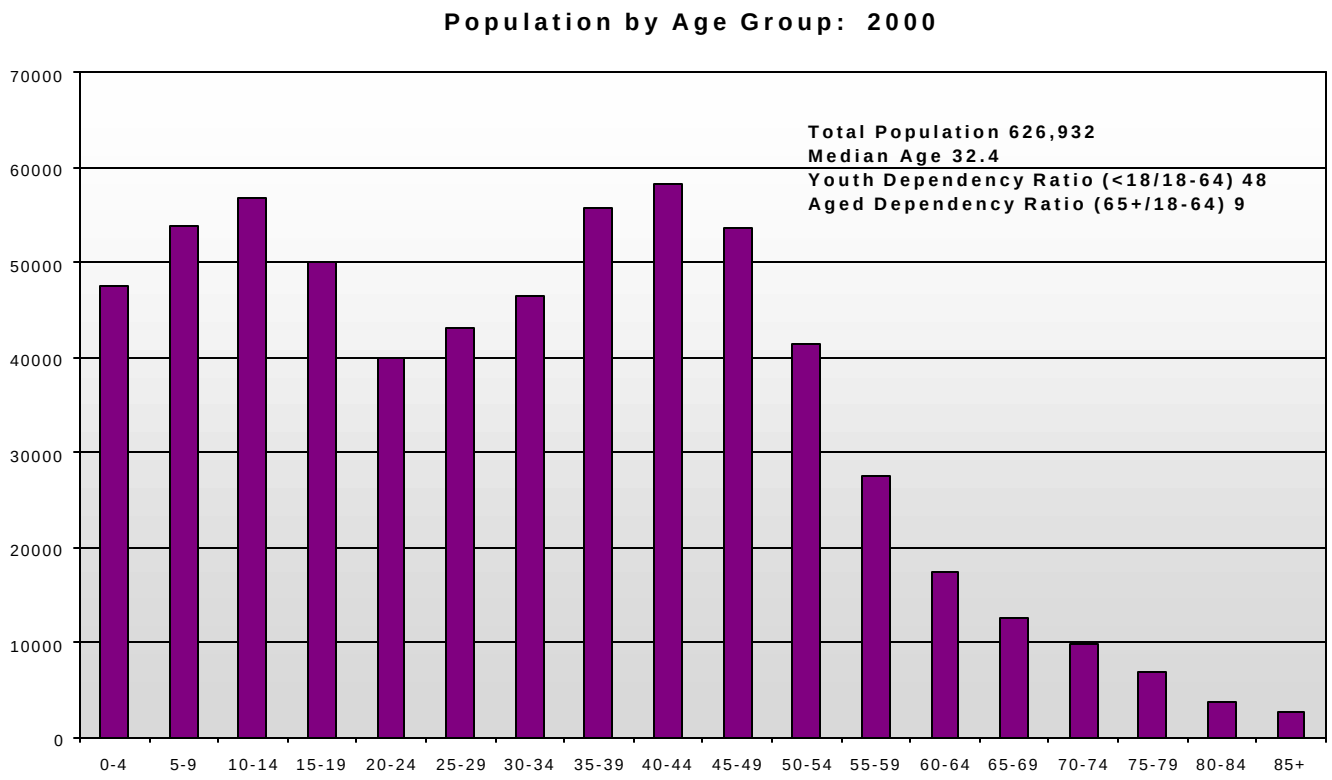


Chart 4

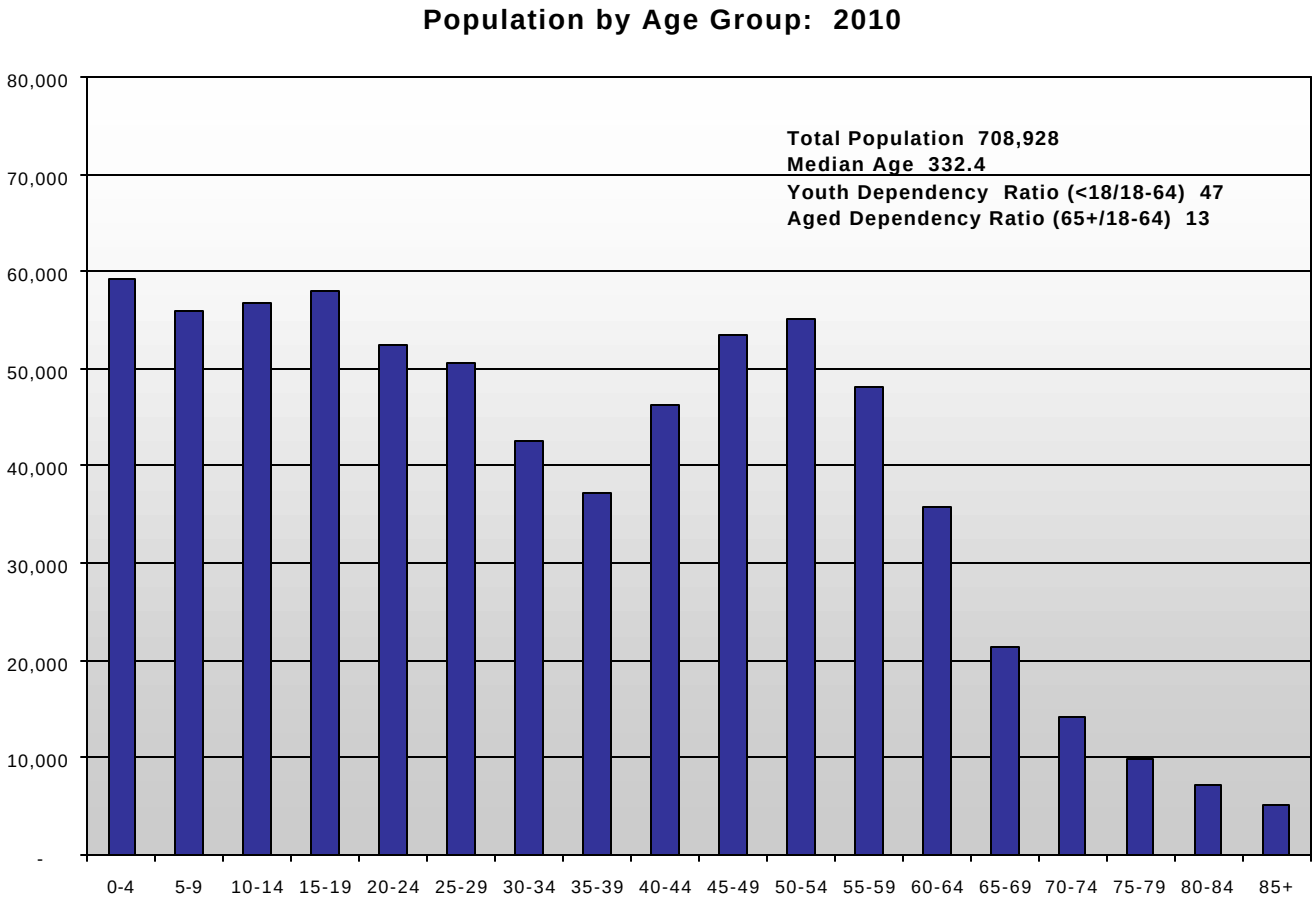


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Chart 5

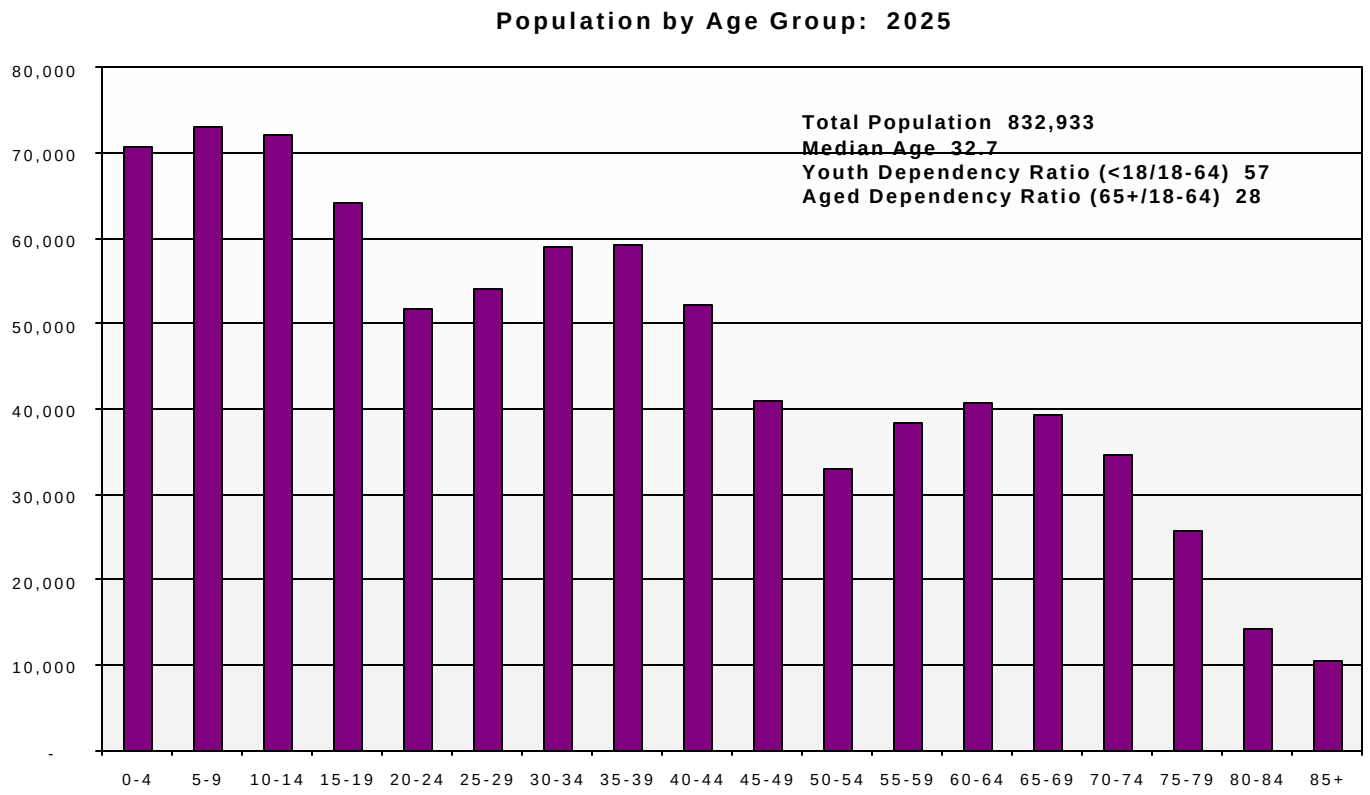
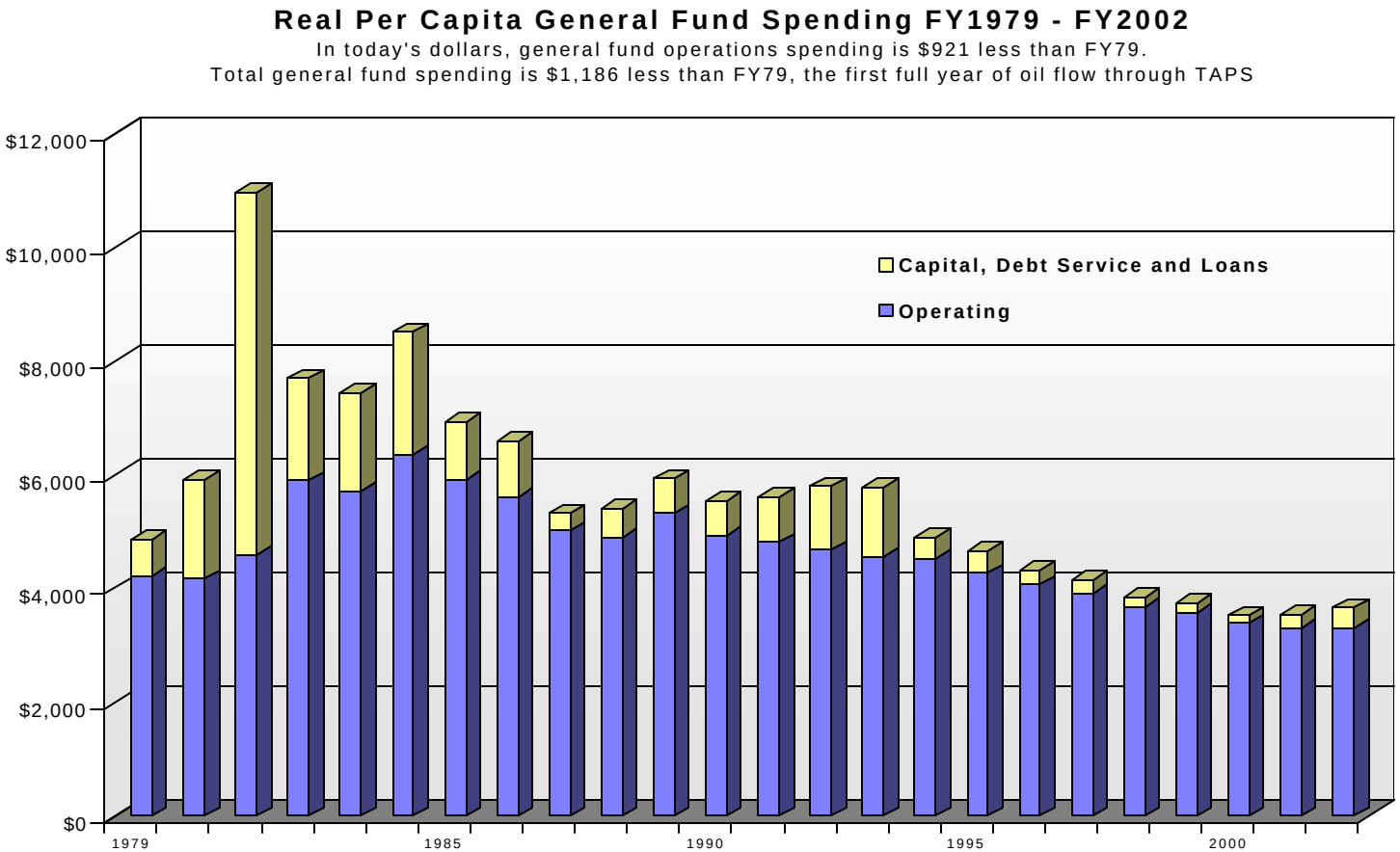


Chart 6



Real Per Capita General Fund and PFD Spending FY1979 - FY2002

State general fund spending including PFDs will be $534 more per capita than FY1979.

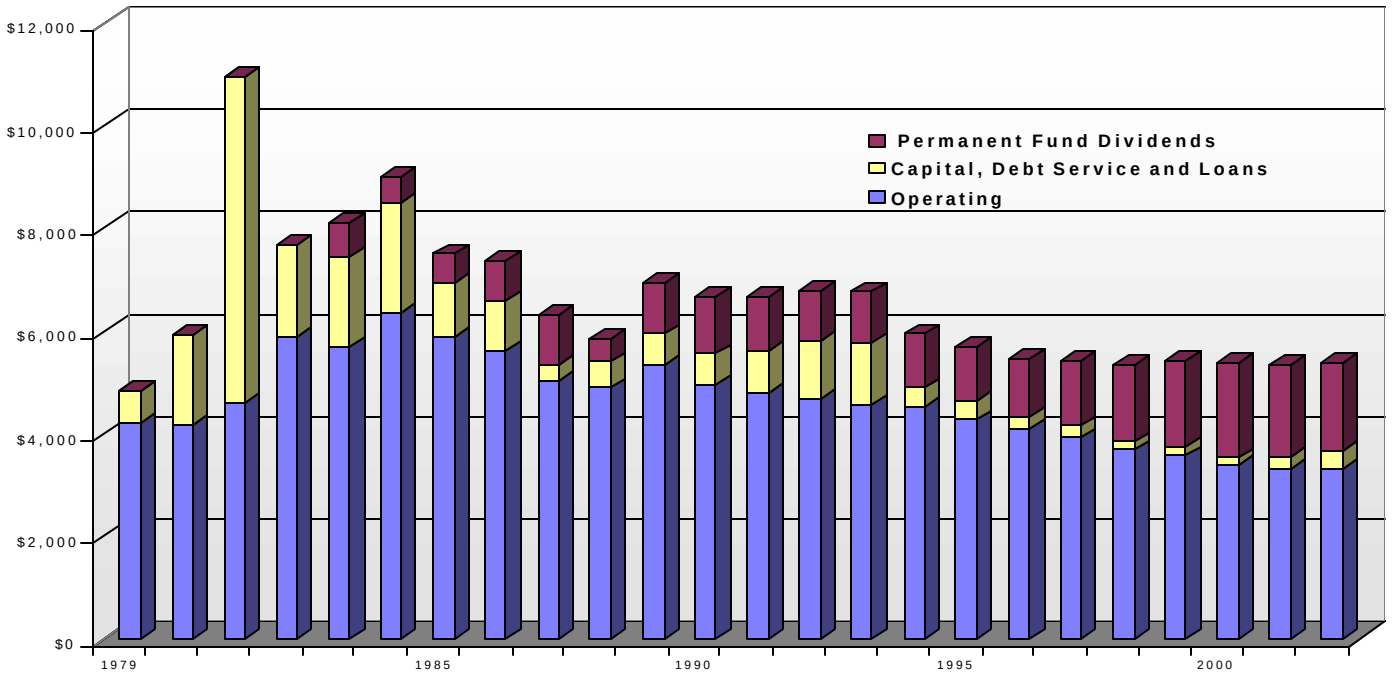
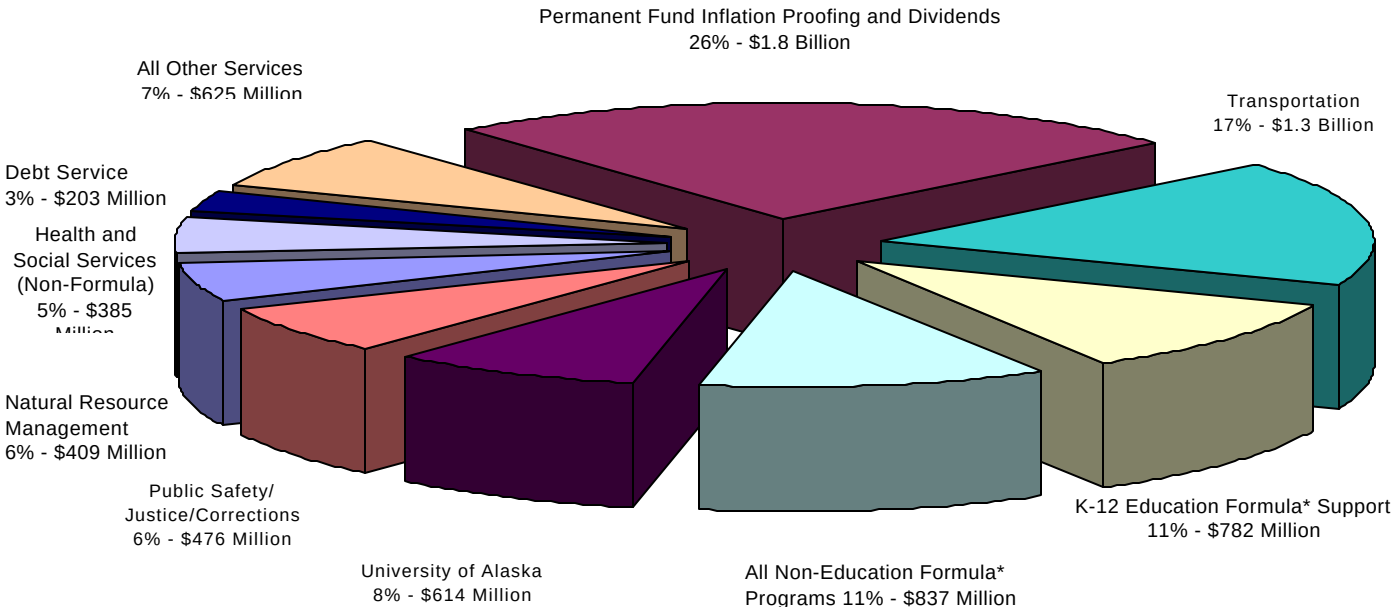


Chart 7

Chart 8

FY 2002 Total Funds Budget by Program Area
Capital and Operating: $7.2 Billion

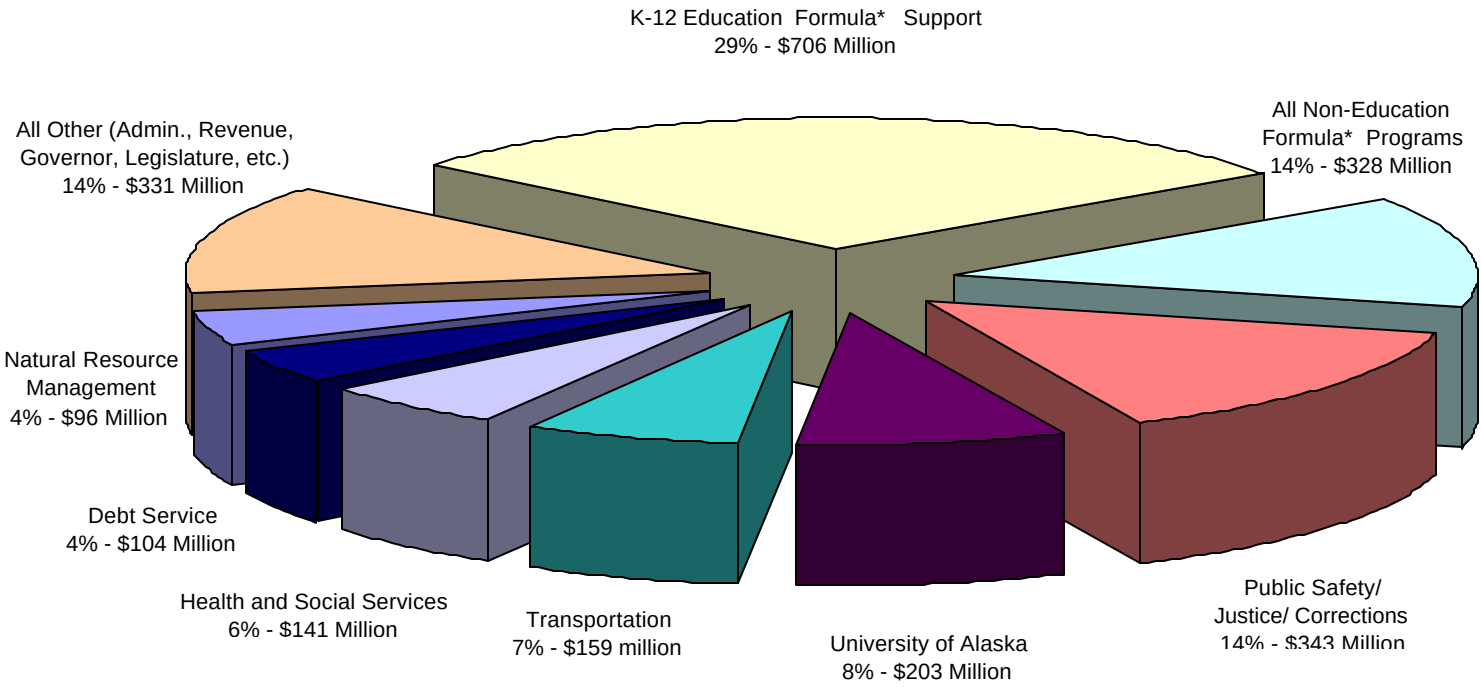


Office of Management and Budget, 07/01

*Formula programs are based in statute and guarantee a specific level of benefits to qualified recipients.

Chart 9

FY 2002 General Fund Budget by Program Area
Capital and Operating: $2.4 Billion



*Formula programs are based in statute and guarantee a specific level of benefits to qualified recipients. Non-education formula programs include: Medicaid, Adult Public Assistance, Longevity Bonus, Revenue Sharing, Foster Care, Elected Officials Retirement, Shared Fisheries Business Tax and Temporary Assistance.